



Corporate & Securities | Alert

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Corporate & Regulatory Compliance: Are You Asking the Right Questions?

Due to regulatory changes made in response to the financial crisis of 2008, market participants entering into over-the-counter derivative transactions and their associated agreements face a vastly different landscape than several years ago. Competing (and sometimes inconsistent) legal regimes across jurisdictional boundaries create opportunities for regulatory arbitrage; more often, however, they merely create confusion.

Parties should not enter into trading agreements or begin trading without first considering all the risks, which undoubtedly now include regulatory and compliance risks. The law as it currently stands is complex, and it changes frequently.

The following list of questions should be considered before entering into an ISDA Master Agreement, a Master Repurchase Agreement, a prime brokerage agreement, structured loan with accompanying hedge swap, or any trading or custody agreement.

We would be pleased to discuss these questions or any other issues that might arise in connection with your business:

1. What kind of trading, prime brokerage, or other customer agreement are you entering into? For example, are you entering into a Prime Brokerage (Reg T, Portfolio Margining or Enhanced Leverage), ISDA Master Agreement, Futures & Options Agreement, Repurchase Agreement, or Securities Lending Agreement? Certain representations, margin methodologies, automatic debits and liability terms may need to be revised;
2. Are you trading exchange-traded derivatives (whether on a Swap Execution Facility or listed trading on exchange)? Eligible collateral, default waterfalls, and stress testing models with house and exchange margin requirements, among other terms, may need to be discussed and negotiated;

3. Are you setting-up a custodial or prime brokerage account? There are different options and relevant issues surrounding rehypothecation, margin, cross-netting and automatic debits to address;
4. Are you entering into an ISDA Master Agreement? There are significant terms that need to be negotiated in light of your strategy, size and life of the portfolio/trades. You should also understand the risk associated with certain terms and representations in the agreement, and whether your entity type must use certain appendices or forms;
5. If the answer to (4) is “yes,” consider which ISDA Protocols are mandatory and which elections are appropriate. Elections may be made under oath.
6. If the answer to (4) is “yes,” and especially if you are a hedging entity, have you considered all of the Eligible Contract Participant requirements for all the parties involved;
7. Are you only entering into the swap to hedge commercial risk? If so, have you identified and considered the appropriate filings and elections;
8. If the answer to (7) is “yes,” and you would like to avoid costly character and timing mismatches, tax hedging identification must be done in a timely manner;
9. Are you “repo’ing out” assets, or are you taking assets in on repo? If so, the way in which the repurchase agreement is structured could affect its characterization for United States federal income tax purposes. Depending on your tax status, your counterparty’s tax status, and the type of assets being repo’ed, this could have significant repercussions for your tax liability, or for that of your counterparty;
10. Are you taking a position in an equity derivative that references dividend-paying shares issued by a United States resident corporation? If so, there are new rules regarding withholding tax on dividend equivalent payments on U.S. equity derivatives; and
11. If you are an investment fund, a bank, an insurance company, or any other entity classified as a “foreign financial institution” for FATCA purposes, consider what KYC and due diligence procedures may be required or advisable.

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